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FSA Proposes to Amend Proportionality Provisions of the Remuneration Code

On 26 July 2012 the UK's Financial Services Authority ("FSA") published a consultation paper on proposals to amend the proportionality tier provisions of the Remuneration Code. The proposed new approach, which will replace the current four-tier structure based on either assets or regulatory capital and its activities with a new three-level system based on a firm's total assets[1], is intended to simplify compliance with the Remuneration Code. All FSA-regulated firms should reappraise which of the three new levels they would fall into and the potential consequences.

Background

The FSA Remuneration Code reflects legislative measures at an EU level set out in the third Capital Requirements Directive[2] (known as CRD3). Broadly, it applies to all firms regulated under the Markets in Financial Instruments Directive ("MiFID")[3] but is subject to change, depending on the final details of equivalent provisions issued pursuant to the Alternative Investment Fund Managers Directive ("AIFMD")[4]. The FSA's "General Guidance on Proportionality"[5] sets out a tier-based structure applying the Remuneration Code[6] and the Pillar 3 disclosure rules[7] differently depending on the proportionality tier into which a firm falls. The FSA currently categorises firms into four tiers. Firms in tiers one and two are subject to the most onerous obligations, whereas tier three and four firms are able to disapply some of the more restrictive provisions of the Remuneration Code, such as the requirement to defer vesting of minimum portions of variable remuneration. Tier three and four firms are also subject to less onerous requirements for public disclosure

[1] This consultation is available at http://www.fsa.gov.uk/static/pubs/guidance/gc12-10.pdf.

[2] Directive 2010/76/EU amending Directives 2006/48/EC and 2006/49/EC. On 20 July 2011 the European Commission published the CRD IV Proposal, which is designed to strengthen and stabilise the banking and wider financial systems. The Commission is aiming for the final CRD IV Proposal to be applicable as of 1 January 2013.

[3] Directive 2004/39/EC.

[4] Directive 2011/61/EU amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

[5] Available at http://www.fsa.gov.uk/pubs/guidance/fg11_22.pdf.

[6] The remuneration code is set out in Section 19A of the Senior Management Arrangements, Systems and Controls ("SYSC") of the UK FSA Handbook.

[7] The Pillar 3 disclosure requirements for remuneration are set out in Section 11 of the Prudential sourcebook for Banks, Building Societies and Investment Firms ("BIPRU") of the UK FSA Handbook. Pillar 3 complements the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). Its aim is to encourage market discipline.

under the Pillar 3 disclosure rules. If a firm is part of a group containing more than one regulated firm, all the regulated firms in that group are subject to the highest tier applicable to any one individual firm. On a solo basis, categorisation into a specific tier is determined by the level of capital resources on the last accounting reference date of the firm under consideration. For third-country firms (*i.e.*, non-EEA firms that do not have their head office in the EU), categorisation into a specific tier is determined by the level of relevant total assets of the firm that cover the activities of the UK branch operation on the previous 31 December. These tiers are proposed to be replaced by three new "levels" calibrated in all cases by reference to total assets.

Proportionality Changes

Under the proposed new framework, UK banks, building societies and certain other investment firms will fall into level one if their average "relevant total assets" exceed £50 billion, and level two if they are between £15 billion and £50 billion. All other UK banks, building societies, investment firms, limited licence[8] and limited activity[9] firms will fall into level three. For the purposes of the proposed new framework, firms which previously fell into the tier four category (limited licence and limited activity firms) would now be treated as level three firms, regardless of their relevant total assets. "Relevant total assets" for these purposes means the average of the firm's total assets (or, for third-country investment firms, the average of the firm's total assets that cover the activities of the UK branch) on the firm's last three "relevant dates". For third-country investment firms the relevant date is 31 December and, for all other firms, it is the last accounting reference date. The switch to a three-year average, as opposed to relying solely on the last accounting reference date, should provide a more accurate reflection of a firm's overall size and business operations. It is difficult to assess whether the move from using a BIPRU firm's[10] capital resources to the relevant total assets will have an effect on the proportionality level of the firm, as the total assets threshold is arguably a cruder way of distinguishing between the tiers than capital resources.

Disapplication of Certain Provisions of the Code

The consultation provides that, subject to the overriding requirement that remuneration strategies reflect sound risk management, it will normally be appropriate for level three firms to disapply the application of the following rules:

- the requirement for a minimum portion of variable remuneration to be delivered in the form of shares or similar instruments which must be also subject to a minimum period of retention (SYSC 19A 3.47R);
- the requirement for deferral of a minimum portion of variable remuneration (SYSC 19A 3.49R); and
- the requirement for performance adjustment of variable remuneration between the award date and vesting (*i.e.*, bonus clawback or malus) (SYSC 19A 3.51R).

The consultation also indicates that it may be appropriate for firms that were previously tier four firms (*i.e.*, limited licence and limited activity firms, who would now be categorised as level three firms) to disapply the requirement to set appropriate ratios between fixed and variable remuneration (SYSC 19A 3.49R), but other level three firms (*e.g.*,

8 A limited licence firm is an investment firm that is not authorised to provide the investment services of dealing on own account or underwriting and/or placing financial instruments on a firm commitment basis, or a UCITS investment firm.

9 A limited activity firm is an investment firm that deals on own account only for the purpose of fulfilling or executing client orders, or gaining entrance to a clearing and settlement system or a recognised exchange when acting in an agency capacity or executing a client order.

10 A BIPRU firm is a firm that is neither a limited activity firm nor a limited licence firm.

UK banks or building societies with relevant total assets below £15 billion) would not be able to disapply this requirement.

Pillar 3 Disclosure

The proposed guidance contains a table setting out the FSA's requirements in relation to the Pillar 3 disclosures relating to remuneration by firms. All firms will be required to produce information with respect to the decision-making process used to establish their remuneration policy and structures, in addition to aggregate quantitative information on remuneration, broken down by senior management and risk-takers. Furthermore, level one firms will be required to provide details of new sign-on and severance payments made, as well as details of the highest severance award made to a single person in that financial year.

The requirements as to what information would have to be disclosed as part of the Pillar 3 disclosure requirements have not changed, except that the requirements for disclosure for level three firms reflects the current disclosure requirements for tier four firms. Accordingly, for firms that are currently in tier three, the proposed new disclosure requirements represent a modest decrease in the level of disclosure that will need to be undertaken.

Who Will Be Impacted?

Although the proposed new framework is not likely to have a very significant impact on current tier three or four firms (who will most likely still fall within proportionality level three), it may result in tier one or two firms being assigned to a lower proportionality level. This will potentially have a significant effect on the extent to which such firms apply the Remuneration Code and Pillar 3 remuneration disclosure rules.

For example, a third-country firm with average relevant total assets of its UK branch operations of £26 billion for the last three years would have previously fallen into tier one. Under the proposed new framework, such a firm will now fall comfortably into proportionality level two. Consequently, this will lessen the Pillar 3 disclosure requirements such a firm will be required to make. In particular, it will not be required to disclose information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based[11] nor will it be required to disclose the main parameters and rationale for any variable component scheme and any other non-cash benefits[12]. In addition, the firm would not be required to provide a breakdown of the aggregate quantitative information on remuneration to show, for instance, the amounts and forms of variable remuneration, deferred remuneration or the amounts of severance payments awarded during the financial year. Furthermore, a third-country BIPRU firm with average relevant total assets of its UK branch operations of £10 billion for the last three years would have previously fallen into tier two but under the proposed new regime will fall within proportionality level three. Under the proposed new regime, such a firm will be entitled to disapply certain provisions of the Remuneration Code as set out above, and the Pillar 3 disclosure requirements will be much less onerous. For instance, such a firm will not be required to disclose information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria[13], and the firm will not be required to break down the aggregate quantitative information on remuneration to show the split of fixed and variable remuneration[14].

[11] BIPRU 11.5.18R(4).

[12] BIPRU 11.5.18R(5).

[13] BIPRU 11.5.18R(3).

[14] BIPRU 11.5.18R(7)(a).

Conclusion

The FSA consultation closes on 6 September 2012 and, if implemented, the guidelines are likely to take effect at some point later this year. The timing is noteworthy, given that the European Securities and Markets Authority ("ESMA") is concurrently consulting on remuneration with reference to fund managers pursuant to the AIFMD. So, while for now, some investment firms will not experience any change to their current remuneration policies (and those that are affected will likely find their burdens reduced), the real changes in store for fund managers will be revealed when ESMA publishes its final report on remuneration at the end of this year.

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